

Emerging Issues Forum 1988
TAKING CONTROL OF THE FUTURE

"Taking Control of the Future"

By

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North Carolina State University

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Keynote Speaker, *Paul A. Volcker*

It's wonderful to be introduced by an old friend and Federal Reserve colleague like John Medlin. His bank, I think I can say, took less supervision than most. I'm not sure that's an enormous compliment these days, but, I tell you, John and I used to see eye to eye pretty frequently. It's kind of dangerous when you think all those other fellows are wrong and we're right, but it was nice to have John on my side or vice versa.

I thought he was going to get so wound up about Benson--between "rest stop" and "resume speed"--that he wouldn't tell you about my wife's ancestry. This is the only place I can get credit for it. You know, her family--her immediate grandfather, that part of the family, left Winston-Salem about a hundred years ago to go north, and she ended up in Jersey City.

I don't know what that said about the sense of judgment on that side of the family. She may keep me under control, but they didn't have much sense of direction. In any event, Chancellor and Governors, Lieutenant Governor, Presidents, Deans--in my new academic capacity I want to be particularly respectful of the deans--ladies and gentlemen, I want to say first of all I'm delighted with the theme of this forum, "Taking Control of the Future."

You know, there's always a kind of doomsday school around, the idea that we're caught up in some kind of inexorable historic forces, economic or otherwise, that say something bad's going to happen, and we can run for the storm cellars. But that's about all we can do about it.

I think while the strand's always there, it normally runs against the grain of optimism in America, but not now, not now. If I judge from the fact that two professors are on the bestseller list, one from Dallas and one from Yale, neither of them from North Carolina, but they are on the bestseller list with doomsday stories, telling us on the one hand that a great new depression is inevitable and that meanwhile we're in the midst of disintegration of the United States' political influence around the world, and that seems pretty inevitable, too.

Well, let me say I don't believe it, either in those particulars or in the general doomsday scenario. What I don't believe is the inevitability part of it, but I do want to say also that in some respects we are doing a pretty good

job of inviting economic trouble, of inviting economic decay, and indeed, inviting loss of political influence around the world. Now, maybe the popularity of those doomsday books reflects a kind of collective guilty conscience, a guilty conscience that we have in fact been letting things slide economically, even though our common sense tells us that there is something out of kilter. We've been putting off decisions about the dollar, the deficits, and our position in world markets, and I suppose we do so on the thought that those decisions are difficult, and meanwhile we can live a little better and live a little more comfortably.

The trouble is, I think that's an illusion. Maybe it's true it's the next generation that'll have to pay the bill, but that's a long time off, and we can tell ourselves the next generation is going to be better off anyway. But I suspect we're taking too many economic risks in a much shorter time frame than that: the risk of a nasty recession or renewed inflation or both, if we don't face up to some of those imbalances that are clearly in the national economy.

Now, if all that sounds a little dramatic or alarmist, let me just try to put the case for you to judge as simply and as directly and as dispassionately as I can, and in doing so let me say I'm not really at all pessimistic. The point of it all is to support the proposition that in fact "we can take control of our future."

There's not in my judgment anything impossible about our economic problems. We have indeed made a lot of progress in the last decade. The kinds of things that we should be doing don't seem to me nearly so difficult as, say, what was done by monetary policy or otherwise at the beginning of this decade when interest rates reached 20 percent or more, inflation was in double digits, and then we had the biggest recession of the postwar period.

Those were difficult times, and compared to those times there's nothing impossible about our problem, provided, that is, we understand the problems and we work away at them doing things, I suppose, that don't come naturally -- don't come naturally, least of all, in an election year. Now, my sense is that we probably have enough economic momentum to get through this year, even if politics tends to forestall some needed policy initiatives. But I also think we'd better use that time to prepare for action, or we may find that the time doesn't exist at all. Markets have a way of getting things done and getting impatient when they don't see progress.

I suppose my story really starts a decade or so ago, when inflation was still accelerating; it was the longest and largest inflation we've had in the history of this country. In other respects the economy wasn't performing well, and I think those phenomena were related. And there was a kind of groundswell of opinion then that something had to be done about it, and the country was ready to support, in my judgment, strong action to do something about it, and did support that action.

But, of course, as I said, in the process of straightening out inflation, we went through a big recession, and I'm not going to rehash all of that, except to say that those dislocations should be close enough in memory so that it should be warning enough of what happens when inflation does threaten to become a way of life.

Now the inflation has subsided, and we can look upon quite a different picture. Six years--in the sixth year of expansion, a peacetime record, 14 million more people employed than at the beginning of the decade, unemployment lower than in a decade, more people of working age at work than ever before since we've taken those statistics; despite what happened last October 19, substantially higher stock prices, higher bond prices, lower interest rates; and, of course, the best price performance in decades.

I must say if I were campaigning in North Carolina I'd stop this speech right there, but I'm not campaigning, and I'm honorbound to continue, and the fact is we had better recognize that success has been dependent upon some factors that simply can't be sustained. We have time, as I suggested, to do something about it, but we'd better get at it, and let me condense the analysis into three simple points.

Point one seems to me now widely accepted, and I think it has to be accepted by anybody looking at the facts, and the point that leaps out from any analysis of the current economic situation is that as a nation we are spending significantly more than we are producing. Now, I could've said that two or three years ago. I change the statement slightly now. Unlike the situation two or three years ago, when we were still recovering from recession, today we're not only spending more than we are producing, I think we are spending more than practically we can produce for the time being.

What's the evidence for that? I mention that unemployment is as low as it's been in a decade, and labor shortages are beginning to show up in

some parts of the country. Even more to the point, we are operating surprisingly close to capacity in increasing numbers of industries, particularly those industries in which we are most clearly internationally competitive: industries like paper and chemicals, even textiles that went through a hard time and reduced capacity; some areas of electronics; the steel industry itself that's reduced capacity; and aluminum, operating close to a hundred percent capacity.

And at the same time we're not investing enough to expand that capacity, certainly not very rapidly in manufacturing industry. In fact, our investment spending after deducting depreciation is historically low relative to the gross national product. Productivity growth is historically low, too, if we can believe the figures. That's not so much true in manufacturing, but it appears we're getting almost no productivity increase in the rest of the economy.

And with investments so low, the conclusion seems to me inescapable that we are just not spending too much, we are consuming too much. We're consuming too much as individuals or as governments or both. Relative to the GNP, it's not investment that's high; it's consumption and government spending that are at historic highs. Now, the measure of that overspending--in a sense, it's provided a safety valve for the pressures--has been rising imports, imports that are running \$150 billion or more a year in excess of exports. That's about 3-1/2 percent of the gross national product.

But let me put the same point another way. We're saving too little. I don't want to fill you up with a lot of figures, but let me just use a few more. We save--have saved for some years in this country on the average--saved as individuals and saved as businesses--8 or 9 percent of the GNP net of depreciation. That is low by world standards, down near the bottom, but that's where it was. Low as that was by world standards, it's tended to decline in the last few years down to around 7 percent.

Against the 7 percent of savings we're running a federal deficit of about 3-1/2 percent of the GNP that has to be financed. Half those savings, in effect, can be counted against financing the federal deficit. That leaves the other half, about 3-1/2 percent of the GNP. That's not nearly enough to cover our needs for investment, whether business investment or housing, even though they are not exceptionally high at this time.

We solved the problem, all right. We solved it by borrowing capital from abroad, by using the savings of the rest of the world, by using, in effect, our national credit card. And I suppose on that scale of things it's somewhat like the experience with the American banking industry, than they make credit cards available pretty freely these days even when you don't ask, and the foreigners for a while were sending us more money than we were asking, and it sent the dollar up and facilitated all those imports, and it was all very convenient.

We wanted to spend, and they wanted to lend, but by now we've run up a sizable bill, going on to a half a trillion dollars by the end of this year. And that doesn't make us, for good reason, entirely comfortable. We're not comfortable when we see the United States as a net international debtor, and the world's biggest. I think we're a little ambivalent about seeing our companies bought up increasingly frequently by foreigners.

But more important than those kind of vague feelings, the money isn't coming so easily now, now that the debt has piled up. Last year on balance we apparently had no net private capital inflow from abroad. Some came in to buy our companies and some flowed out, and it about balanced. Pretty much all the net capital inflow, which was very large, came from foreign governments and foreign central banks that were trying to support a weak dollar.

So by this time if we're not exactly international beggars, we're no longer in a position to be very choosy about our creditors. More important even than that, we don't like and we shouldn't like the size of our trade deficit, but that trade deficit goes hand in hand with borrowing from abroad. It's part of the same process. And if we're going to get rid of the trade deficit and stop borrowing abroad, then how are we going to finance the federal deficit and finance our investment?

The fact is we're going to have to stop spending so much and begin saving more, and there isn't any amount of talk or any amount of rationalization or any monetary or exchange rate manipulation that can get around that simple point. Sooner or later we're going to have to stop living beyond our means. Now, I don't mean to make that sound so awful, particularly in the State of North Carolina, that I was told at a dinner tonight has a bigger percentage of manufacturing than any other state in the union.

It does mean, and there's no getting around it, that for a while per capita consumption is going to have to grow much more slowly or even level off. But there are going to be big opportunities in this situation. As consumption levels off, we should be seeing more investment, and we should be seeing more exports. And we're going to need to see more exports. And exports and investment mean more manufacturing.

If we are going to get rid of our trade deficit over the next four or five years, and I think that's a fair assumption, we're going to have to increase manufacturing output on top of everything else by, let's say, \$150 to \$175 billion. Manufacturing output today in the whole country valued at the factory gate isn't much more than a trillion dollars, so I'm talking an increase of manufacturing of 15 to 20 percent on top of normal growth in the economy. That is a pretty good outlook if you are a manufacturer in very sharp contrast to the sluggishness of manufacturing in the United States over the past five years or so relative to the rest of the economy.

And my second point is that there aren't any really automatic easy ways to bring about that result--reduced rate of consumption, increased manufacturing, increased exports, increased investment--painlessly. Now, you might ask about simply letting the dollar decline further, and let me look at that proposition. I don't think there's any doubt that the dollar did have to decline from the very high levels it reached in 1984 and early 1985. It had to decline to give our industry a competitive opportunity.

But now there are a lot of indications that our industry is competitive and should be able to remain competitive if they work away at efficiency and productivity. Our labor costs in this country on the average are not actually significantly lower per hour than in northern Europe, in Germany and Scandinavia and Benelux.

We used to think of the Japanese wage scale as being way below ours, but it appears now that in manufacturing as a whole Japanese labor costs are about the same as in the United States, so we start in that sense from a level playing field. Our exports have been rising rapidly in volume terms for two years, up about 15 percent last year, and our companies achieved that increase in exports despite the fact that many of their markets abroad were sluggish.

I noted before we had some actual and potential capacity problems reflecting that surge in exports. Now, in those conditions a further decline in

the dollar seems to me dangerous. It could be substantially inflationary, raising costs of imports and actually slowing down the improvement in our external trade in dollar terms. At the same time, further weakness in the dollar after the decline that John Medlin mentioned could only make the foreigners even more reluctant to lend to the United States, and we're going to have to continue borrowing, however well we do, for some years.

Taken together, those factors could only tend to drive interest rates higher, and the related lack of confidence would spread to other financial markets, and didn't we see something of that in the late summer and fall? And at the same time, ironically, the effects of further declines in the dollar would be to depress foreign economies, which wouldn't help the markets to which we have to sell. That's a result we don't want and would increase the risks of world recession.

So in all those circumstances my conclusion is a further dollar decline would plainly be counterproductive, and that, of course, at least recently, is the position taken by administration officials as well. A further dollar decline would make us poorer, not better off. Well, if that doesn't work, how about increasing private savings? And I'd like to think that's the answer. It's fine, but I have to tell you I think it's unlikely.

To close the gap in our savings and our investment needs and our deficit by an increase in savings alone, they'd have to rise about 50 percent. Well, what's the historical pattern? It is a very steady figure tending to decline over the years, not to increase. And it's been a very steady figure with a lot of tax changes. It's been a very steady figure in inflationary years and years of price stability. It's been pretty steady in years of high interest rates and low interest rates. It's been pretty steady not just in the United States but abroad.

I think all of history tells us that savings are pretty deeply embedded in social attitudes in the national psyche, and you're not going to change it very rapidly just by wishing it was so or even by tinkering with the tax structure. Well, what about growing out of the problem? Well, that may have sounded plausible a few years ago when we were in recession, but not now. We simply don't have that kind of growth potential.

Our labor force grows a little bit more than 1 percent a year. Our productivity has been growing a little bit more than 1 percent a year. That's where growth comes from. Add them together and you get something like 2

to 2-1/2 percent growth potential, assuming the unemployment rate can't decrease a lot more, which I think historically is a reasonable assumption. So it's going to take us time to grow out of the problem, too much time.

And I suppose we could say as a last resort let's approach the problem directly. We can simply bar imports. Let's put on some tariffs and some quotas and really go at it directly. Well, I'm not going to debate that at great length, because I hope the dangers of the United States turning protectionist are both well recognized by this time and receding.

But let me point out that unfair trade practices can't be the whole story here, much as we must regret and work against the restrictive trade practices of others. I don't think there's any doubt that on balance they are biased against the United States' trade, but I don't think they're more biased than they were a decade ago. In fact, in the last decade the United States has put on more trade barriers than foreign countries and I have to remind you, a decade ago when these things were biased against us, we did manage to run a trade balance and trade surplus, so it's not impossible.

And my third point follows directly from the first two, that is that we're spending too much and there's no easy, automatic solution. The third point is that there are in fact solutions. There are two kinds of solutions. There are constructive solutions, and there are the other kind. And let me describe the second kind first.

I assume, and I think it's a sound assumption, that we cannot go on running so large a trade deficit indefinitely, that we cannot continue to increase our debts to others indefinitely. It's not a sustainable process politically, but even more certainly it's not a sustainable process economically. It contains the seeds of its own destruction. After a while your debts get big enough that nobody will lend to you.

So what's the implication? If it's a policy matter we rest on our laurels, and we don't do anything. Confidence is going to be undermined, and the money won't flow easily to the United States from abroad. We can't command foreign savings. We have to earn it by performance. And if confidence and patience run out, and nobody can say when or where, then the dollar will be at risk, interest rates will be at risk, and the stock market will be at risk. That indeed will stop overspending! The market will work! But what a potential witch's brew we risk in the process: more inflation,

strains in financial markets, lower stock prices, and a recession, too. That can't be the way we want to proceed.

I'm reminded--it may only be a sad story that affects central bankers, but let me relate the story anyway. Back when Mexico first had their international financial crisis, ran out of money back in 1982, I was being visited quite frequently by the finance officials of Mexico, and they told me this story--this true story. They said sometime in early 1981--I don't know exactly when--some of the financial officials of Mexico had gotten word of the rate of speed that they were borrowing abroad, and relative to the size of their economy they were borrowing a lot.

And they finally screwed up their courage and went in to see the President, President Jose Lopez Portillo, and they explained to him they thought the country was borrowing too much, and they were going to run out of credit, and they'd better slow it down, they'd better take some actions to restrain consumption in the Mexican economy. And the president said, well, he'd consider that. And he went and talked to some of his political friends, and he talked to some of the foreign bankers, and he talked to others, and the foreign bankers in particular told him they were ready to continue to lend Mexico a lot of money, and in fact they were lending it at lower and lower interest rates during that period, and they in fact lent Mexico \$20 billion--it was an awful lot of money for Mexico--in one year, 1981.

And the president reacted as I suppose presidents are likely to react under those circumstances. He dismissed the financial officials and went ahead with an economic expansion with an election approaching. But before that election got there in the middle of 1982, the money suddenly stopped. And it didn't stop gradually. It stopped from one month to another, where Mexico couldn't borrow anything. And Mexico had a fairly stable economy before that in exchange rate terms and inflation terms. The peso then was about 12 to the dollar. Today it's 2,250 to the dollar. They've had almost no growth in Mexico during that period of years. They are still struggling, although I think there are signs of improvement now.

Now, the United States isn't Mexico. We have a lot more rope. We've got a lot more strength, but I think there are some lessons in that experience and how markets act when they finally act. Well, if that's not the alternative, what is? I'm sure none of you are sitting on the edge of your seat waiting for what I'm going to say. The fact is we have to face up to our

domestic budget problem. That deficit by no coincidence is just about as big as the foreign deficit, running more or less 3-1/2 percent of the GNP.

It's no coincidence we're in effect borrowing abroad to pay the government deficit. In the short run that's nice and comfortable. We can have our cake and eat it, too. In the long run that only makes us poorer, and I'm afraid that sometime--a year from now, two years from now, three years from now--the markets are likely to take over and say, "Stop it!" unless we do something before then.

There's no use believing, in my judgment, the budget problem will cure itself. We're running spending about 15 percent above revenues. Take out a modest estimate of the type of spending that can't be cut--interest, the core of defense spending, most of the entitlement programs--and you've got more than half the budget. If we're going to cure it on the spending side alone, we're going to have to cut that half of the budget by 30 percent or more, and who really, upon careful consideration, can think that's realistic?

I don't. Interest is rising. I think we can afford the defense that we need, and we'd better afford it. And I don't know about you, but when I look around, we're going to have some educational needs, we're going to have some medical needs for an aging population, we're going to have needs for highways, we're going to have needs in space and elsewhere. Sure, we can cut spending. I don't have any doubt about that. Can we cut spending alone by enough to deal with the budgetary problem and meet our responsibilities as a country? I don't see any evidence for it.

I think effective action is going to require some combination of spending cuts, including getting into those infamous entitlement programs, and taxes. Now, let me say I'm not talking about anything horrendous here. I think with an intelligent, balanced program on the revenue side, we can do a lot of what needs to be done by the gas tax, which makes a little sense on conservation grounds anyway. If I wasn't in North Carolina I might even suggest a little cigar tax or increasing the cigarette tax. I think we can do some things around the edges. On the entitlement programs, nobody's talking about cutting them. The only question is whether there are sensible arrangements for cutting the rate of increase, and if we do it in a balanced way and with some revenues in the package and it appears fair, it seems to me it can get done, but it's not going to get done in an election year.

What's disappointing to me is that the way it's going the election campaign may be making it harder rather than easier. I'm sure every day all those pollsters warned the candidates that it's also unpopular, and I suppose it is when you simply ask somebody, "Do you want your taxes increased?" or "Do you want to give up a cost-of-living increase or social security?" or "Do you want to have your social security payments taxed?"

But are we really explaining to those American people what the real choices are? Suppose I am exaggerating a bit. Suppose the prospects of recession and inflation aren't quite so sharp as I have suggested but there's at least a risk. Even then, isn't some insurance policy against inflation and recession worth 10 or 15 cents on the gas tax this year and another 10 or 15 cents next year and even the next year after, bringing our gas tax somewhere, maybe half, to where it is in most other countries?

Can't we ever change our entitlement programs, even though the real income of the average employed person is tending to decline a little bit? We're not talking about big changes, certainly not when measured against the enormous potential of keeping this expansion going, or keeping inflation down, and yes, keeping defense spending at levels compatible with our security needs. Sure, we can sit back and be passive and bask in the thought that it's morning in America.

Then I suspect those doomsayers that have all those books on the bestseller list will prove to be right, not because it's inevitable but because we made that choice with our eyes open--and the clock will be moving from morning till late afternoon--and may be moving on that kind of fast forward that I try to figure out in the motel rooms when I set the alarm clock.

We have too much going for us, too much at stake for me to think we won't do it right, that we won't take control of our financial future. In reality that doesn't seem to me to be the message coming out of this election campaign so far, but that, I suppose, is why forums like this, where the speeches and the analyses don't have to respond to the latest poll, can be so important.

Whatever the stump speeches say, the problem's going to be at the doorstep of the next president and the next Congress, and I, for one, welcome the impact that forums like this can have in shaping our ideas and shaping the debate and shaping opinion so that when that time comes, action will remain possible. Thank you for inviting me to participate.